UNITED STATES DEPARTMENT OF AGRICULTURE
Extension Service
Washington 25, D. C.

LIBRARY
RECEIVED
DEC 1 1952
U. S. DEPT. OF AGRICULTURE

Financing Marketing Cooperatives

by
Oren R. Shelley*

Marketing associations in common with other types of cooperatives and businesses require a certain amount of permanent capital and from time to time borrowed funds are required as supplemental or temporary capital. One of the vital links in the success or failure of any business venture is the manner in which the capital is provided.

In the initial stages of the development of cooperative marketing, the facilities were rather limited and the financial requirements were small. The early cooperative creameries, elevator associations, fruit and vegetable cooperatives were started with humble beginnings and with only a nominal investment on the part of the interested farmers. As time passed, the successful cooperatives grew very materially and have become much more complex as a result of increasing their volume and expanding into the processing of numerous farm products incident to the marketing phase. Some marketing cooperatives have developed into large business organizations that handle and process millions of dollars worth of such agricultural products as grain, cotton, tobacco, dairy products, fruit products, and livestock and livestock products.

The expansion into the processing end has been a natural development arising from an attempt by farmers jointly to gain for themselves as individual farmer members the greatest return possible for the products they produced. Thus modern-day marketing cooperatives, including the so-called small ones, could not have developed without sources of finance. Generally they require relatively substantial amounts of capital funds to provide the necessary facilities, and the operating capital needed to carry out the functions they have undertaken over the years.

Basis for Determining Financial Requirements

One of the first steps in developing a financing program is to determine the present financial condition and requirements of the business. This should be self-evident, but every once in awhile inquiries are made regarding the possibility of a loan without submitting any concrete information on which to estimate the overall capital requirements, such as the amount needed to cover the investment in facilities and in operating capital. Since most of the cooperatives that lending institutions deal with have been in existence for some time, their present capital or financing requirements can be determined as of a particular date primarily from the data furnished by the association's balance sheet. If it is a new association, the lender is interested in analyzing a pro-forma balance sheet.

The balance sheet does not reflect the future needs, but it provides part of the basic information and the starting point from which future requirements can be fairly well estimated. The balance sheet shows the present amount of long-time or permanent capital invested in such items as land, buildings and equipment, stock in other cooperatives or organizations, and assets that partake of the nature of long-term capital such as prepaid expense minimum inventories, minimum receivables, and minimum cash at the low point of the marketing cycle. A balance sheet at the peak of the cycle when compared with a balance sheet at the low point of the cycle will

*Presented at Extension Workshop on Farmers' Cooperatives, Michigan State College, August 1952

provide a basis for determining the short-term or seasonal capital required for carrying peak inventories and receivables that normally will be liquidated into cash at the next low point.

The existing source of the capital is evidenced by the liabilities of the association and by the capital contribution of the members as usually shown in the net worth section of the statement. This shows the financial condition as of a particular date as revealed by the relationship between the liabilities and membership capital and the various assets of the corporation. A series of them indicate historically what the financial condition and requirements have been over a specified period and reveal whether there has been progress or a lack of progress in building the financial structure of the business.

One of the most important figures computed from the balance sheet is the amount of working capital as indicated by the amount that the current assets exceed the current liabilities. Many like to analyze the relationship between the current assets and liabilities in terms of a ratio and talk about a current of 1 to 1 or 2 to 1, etc. This computed ratio is an important index, but in financing its use is somewhat limited unless it is accompanied by the actual amount that the current assets exceed the current liabilities. In a well-financed marketing cooperative the amount of working capital should be sufficient to carry the normal inventories and receivables and provide cash for operations, and to maintain the accounts payable and other current liabilities in current condition - in other words, the working capital should be sufficient so that there would be no past due accounts payable on the books.

The working capital position is an important index for it reflects any increase or decrease in the assets that are not in direct proportion to the increases or decreases in liabilities, membership equities, or reserves. The net working capital also reflects any changes in the relationship between the current liabilities and the term indebtedness and membership equities. Thus, the effect on the financial condition by any proposed changes in assets such as expanding the facilities or the business, or any changes in liabilities by either borrowing or repaying or changes in capital equities by sale of stock or reducing them by paying cash refunds or retiring stock, all may be analyzed by the way such changes affect the amount of working capital.

In marketing cooperatives, the working capital requirements vary widely, and they are dependent pretty largely on the methods of marketing. For example, cooperatives marketing farm products on a strictly pool basis may require little or no working capital; that is, they may be able to operate on a sound basis with a current ratio of 1 to 1. In this case, it is assumed the patrons receive nothing until the products have been processed and sold and returns realized.

On the other hand, a cooperative that pays cash for the product at the time it is delivered by the farmer will need sufficient working capital to be able to finance carrying the product from the time it is purchased to the time it is sold and cash collected. If it takes a long time to realize cash from the product, more working capital is required, and in this connection policies with respect to the terms of the sales and collections have an important bearing on the amount required. Although many marketing cooperatives operate on a pool basis, they make initial advances on the product at the time of delivery. The more prevalent the practice is of making advances, the nearer it comes to a cash purchase basis; the closer an association comes to a cash purchase basis, the more working capital is required. The risks also increase correspondingly, which is an important consideration to the stockholders as well as to the creditors.

Another part of a financial report that a lender looks at is the income and expense statement. A series of such statements show the progress or lack of progress in the operations. Operating statements, like balance sheets, of course, are historical, but they too reflect the effect of policies and operating methods. An examination of them serves several purposes, most important of which is that they reveal the ability of a cooperative to realize net savings and this is tied up with capital generation and debt repayment ability. Their use is essential to provide a base for projecting prospective operations through budgets or otherwise, which is a prerequisite to determining future financial requirements and debt-retiring ability.

Sources of Capital for Financing a Marketing Co-op

There are a number of specific sources where marketing cooperatives obtain financing, but there are really only two general sources - one from the members and patrons of the association, which is the primary source; the other from outsiders, which is a secondary source. Every cooperative should have some permanent membership capital in it, in order to provide a base for obtaining credit if necessary, and to strengthen the member interest in the welfare of his organization. The ideal is where all of the permanent assets and minimum working capital are financed by the members and patrons through their investments in the cooperative. When this point is reached, the only outside funds needed are those required on a short-term basis to assist in financing current operations and to assist in financing peak inventories and receivables. Borrowed term funds, then, are really a part of the cooperative's permanent capital put up by the lenders on a temporary basis until the members and patrons can put all of it in themselves. In general, the only way the members can have a strong and efficient organization is to have it paid for.

Membership Capital

As already indicated, the primary source of the capital is from the membership. If the membership is to furnish the necessary capital, how can this be done? There are several methods used and among them are the following:

In non-stock marketing cooperatives, the membership fee may or may not furnish any appreciable capital. In many instances, the membership fee is a modest one and is looked upon more as a means of evidencing voting rights. The investment capital may be represented by some form of certificate such as certificate of interest, certificate of indebtedness, Revolving Fund Certificate, etc., which in effect is comparable to capital stock. The certificates may or may not have a due date and they may or may not be in specific denominations. If a due date is used, the date should be twice as far in the future as the time in which they are expected to be retired. Non-due date certificates are preferred. The certificates may be sold to the members for the purpose of raising capital or be used to evidence capital raised through retaining net overages in the business.

In a cooperative that is set up on a stock basis the usual method of financing initially is by the sale of capital stock. The stock may consist of only common; in other cases, a combination of common and preferred; and in some cases, the preferred may be divided into various issues such as 1st Preferred, 2nd Preferred, etc., to represent investments for specific purposes and priorities as to redemption. Some associations, in addition to their capital stock, may also use various other forms of certificates to evidence investments. The par value of the stock may vary considerably. Some associations that undertake a stock-selling campaign have preferred to use relatively large par values particularly in communities

where the members are fairly big operators and the investment required in the cooperative is heavy. In other cases, where flexibility is desirable, cooperatives have used stock with a small par value such as $1 or $5 per share. When $1 shares of common and $1 shares of preferred are authorized, the common stock is ussued more from the standpoint of evidencing membership and would be comparable to a membership fee. Only one share of common would be issued to each member. The preferred stock would represent the capital investments. Although the preferred may be only $1 per share, only one certificate need be issued as one may represent any number of shares at the time of issue. For example, one certificate may represent 50-$1 shares of preferred stock just as readily as one share at $50 par.

There are other means of raising capital after an association is in operation.

One of the most common and usually the most important source of capital for building the financial structure is from the net overages from operating the business. In most instances, the bylaws and articles of incorporation provide that the net overages after making provision for dividends on capital stock belong to the patrons, but the net overage may be paid out by issuing some form of investment certificates or credits in a capital account such as at patron's equity reserve rather than in cash and thus retained in the business. The funds so put into the business have come about through patronage and it has been a somewhat painless way in which the farmers have built up their investments in their organization. They have used this device far more than outright cash purchase of stock as a means of financing the growth and expansion of their marketing cooperatives.

Farmers have used another device to build up the ownership capital. That is, by authorizing their cooperative through a contractual arrangement to make a specified deduction or retain per unit of product from the amounts due them for commodities delivered. This is a more positive way of building the financial structure than relying on net overages. The retain is a capital contribution on their part and the cooperative evidences the investment by issuing certificates of capital stock, or other certificates or by credits to a capital account. This method has provided an effective way to build capital in proportion to the use made of the marketing facilities by individual patrons.

As indicated earlier, marketing cooperatives that operate on a pool basis or on a basis where payment for the product is deferred, require less working capital than when cash is paid at the time of delivery. Although the product is pooled primarily for the purpose of gaining the greatest returns for them, incident to this, the commodities themselves provide operating capital. For example, a dairy association which usually follows the practice of paying only once or twice a month for the milk and cream delivered in the previous month usually has processed and marketed the dairy products before it is required to pay for them. The patrons then, through their commodity contributions, provide the working capital instead of the association as such.

The degree to which commodities provide working capital depends on the extent advances are made on them. In some cases, the commodity contributions may serve as the risk capital to margin commodity loans.

Outside Capital

There are a number of sources of outside financing, including Banks for Cooperatives, commercial banks, insurance companies, and other lending institutions, investors who may be interested in buying debentures or preferred stock, and trade creditors who furnish credit on open accounts and installment contracts.

Loans from lending institutions are an important source of temporary capital to marketing associations. The most common, of course, is through mortgaging the fixed assets to obtain long-term as well as short-term loans. In some cases, borrowed funds may be obtained from banks or individuals on unsecured notes. In other cases, funds are obtained by borrowing on various types of commodities that are pledged to the lender under warehouse receipts or other title documents on commodities pledged under an inventory chattel mortgage or factor's lien in states where the statutes provide for such mortgages or liens. Another basis is by assigning accounts receivable that arise from the sale of commodities as collateral for loan advances.

Long-term loans are obtained usually for one or both of two purposes, that of financing an expansion of facilities or for operating capital. Basically, whether or not a lender can make a loan and for how much is determined largely on the basis of the probable ability of the borrower to retire indebtedness. This has to be determined primarily from the current financial position of the association, its record of past operations, prospective future operations, volume of business, the security or any other factor which might have a bearing on the ability to repay a loan. It is probable that the maximum loan any commercial lender would make would in no event exceed the amount put into the business by the members. If a lender should put up more than 50 per cent he, of course, would then have a greater interest in the organization than the members who are the owners and operators of the business.

A term loan, after it has been made, should be sufficient to cover the balance of the facility expenditures and leave the association with sufficient working capital to operate the business satisfactorily. Term loans made by the St. Paul Bank for Cooperatives to marketing associations are usually repaid by monthly payments related to either a definite amount per unit of product handled, or a percentage of sales, or a combination of both based on the business transacted in the previous month. Under this scheme, the borrower pays more as the volume of business and the prices go up and less during the months or period when the volume is down. On occasions, a fixed monthly payment is used, but ordinarily the most satisfactory basis is where the repayment is related to the volume of business as it is more closely geared to the amount of net overages realized at various points of the annual business cycle.

The basis of repayment may vary. Dairy cooperatives may repay at the rate of one or two per cent of gross sales, elevator associations may repay on the basis of one to one and one-half cent per bushel plus one to two per cent on sale of commodities other than grain. A turkey marketing and processing association may repay at the rate of one-half cent per pound. The rate that is provided for will depend pretty largely on the association's ability to realize net overages or on the amount of retain and on the size of the loan. A cooperative that has no net overage from operation has no term debt repaying ability unless a retain is made. If it makes overadvances for the products over an extended period, the loss may offset the retain if one is in effect, and overadvancing is one of the surest and quickest ways of wrecking a marketing cooperative.

Short-term Loans

Many marketing associations store products seasonally and require short-term or seasonal loans. These are loans that are to be repaid as the marketing season reaches its low point. Loans for seasonal operations, where commodities are not pledged for specific advances, may be related to the amount of working capital. The loan would be secured by a lien on the facilities and be limited to say two

times the association's working capital. For example, a dairy association may have $200,000 of working capital. It is probable that, if all other factors are satisfactory, a lender would be willing to provide a line of credit of $400,000. Now, if the working capital decreases $1, the line of credit decreases $2, and the cooperative has depleted its available financing by $3. Conversely if it improves its working capital by $1, a loan may be increased by $2 until the maximum commitment is reached. Under this method, the short-term loan will be equivalent to about 2/3 of the value of the receivables and inventories.

In a fruit association, for example, if the initial advance for fruit is kept moderate and additional advances are made only as the products are sold, a lender may look upon the balance due growers as part of the working capital. This is, the commodity contribution of the growers for which they have not been paid, may be used to supplement association's own working capital as a base for seasonal operating capital loans. The lender then may advance two times an amount equivalent to the association's working capital plus the balance of the amount due growers. Then, as processed fruit is sold from time to time, the seasonal loan is reduced and additional advances are made to the growers.

Where an association is in excellent fiancial condition, it may be possible to make an unsecured seasonal loan on the basis of $1 for each $1 of net working capital; in other instances, it may be possible to work out a partially-secured loan; that is, a loan secured only by a chattel mortgage or factor's lien on inventories and relating it to working capital on a $1 for $1 basis.

Short-term or seasonal operating capital loans ordinarily should be liquidated as the receivables and inventories are liquidated. One test of liquidity and proper financial structure is when an association can pay its seasonal loan in full each year and remain out of debt until the next seasonal increase in business begins. if a borrower is unable to repay its seasonal loan at the low point, it means the inventories and receivables have not been liquidated as they ordinarily should be before going into another season or the association has suffered losses or the working capital has otherwise been depleted.

Marketing cooperatives, in many instances, are in a position to pledge specific commodities under warehouse receipts or other title documents as collateral for loans to finance operations. Advances may be made at the rate of 65 per cent of the value of unhedged commodities and up to 80 or 85 per cent on hedged products. Commodity loans are self-liquidating in that the loan advances made against specific products are repaid at the time the commodities are released. Provision is usually made for an acceleration in the repayment by providing that the commodities will be released upon payment of 110 per cent of the amount advanced.

If a marketing association is short of cash for releasing commodities, it may be possible for it to assign receivables arising from the sale of commodities as collateral for an operating capital loan set up for the specific purpose of releasing commodities. Then, as the receivables are collected, the specific loan advances against them are repaid.

Summary

In working out any financing program for a marketing cooperative, it is essential first to determine what the present financial condition is and what the requirements are. This can be determined primarily by using financial statements as a starting point.

The ideal financial position is where the members own and have paid for all of the permanent assets of the association, including provision for minimum working capital.

Term loans to finance permanent assets are only a means of obtaining the permanent capital on a temporary basis until the members and patrons can put it into the business themselves.

Every association should strive to reach a financial position where the only borrowed funds needed are those to finance seasonal increases in inventories and receivables.